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INTRODUCTION

In accordance with the City Auditor's 1993-94 Audit Workplan, we audited the City of San José's business license tax collection process. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

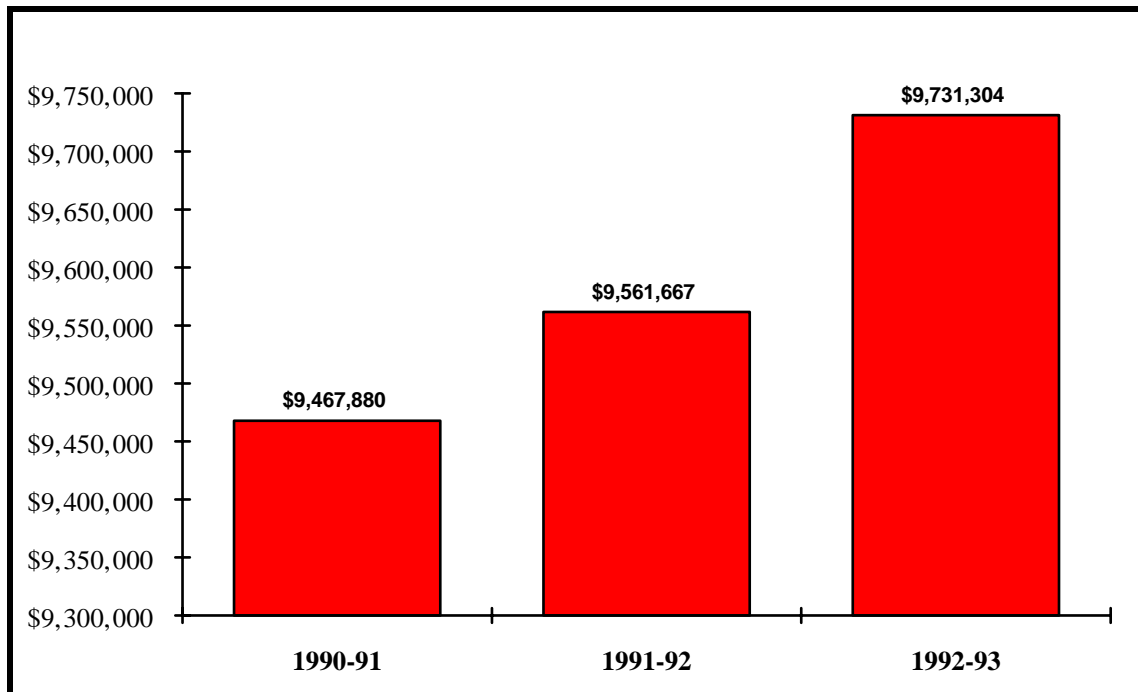
BACKGROUND

The San José Municipal Code, chapter 4.76, “Business License Taxes,” was enacted solely to raise revenue for municipal purposes and not to regulate business. The tax rates as prescribed in chapter 4.76 of the San José Municipal Code have been in effect since January 1, 1984. The business license tax is calculated based on the business’s number of employees (number of rental units for residential landlords and mobile home park owners or number of square footage owned for commercial landlords). The basic business license tax is \$150. Businesses pay additional taxes of \$18 per employee over eight for most businesses, an additional \$5 per rental unit over 30 for residential landlords, an additional \$5 per lot over 30 for mobile home park owners, or an additional \$.01 per square foot over 15,000 square feet for commercial landlords. San José is one of the few cities that still use these bases. Most other cities we surveyed collect business license taxes based on gross receipts.

Three-Year Business License Tax Revenue

The City’s business license taxes and penalties have increased over the past three fiscal years as shown in Chart I.

CHART I
CITY OF SAN JOSÉ
BUSINESS LICENSE TAXES AND PENALTIES
FOR 1990-91, 1991-92, AND 1992-93



The Treasury Division reports the following business license taxes (excluding penalties) collected in 1992-93 by type of business:

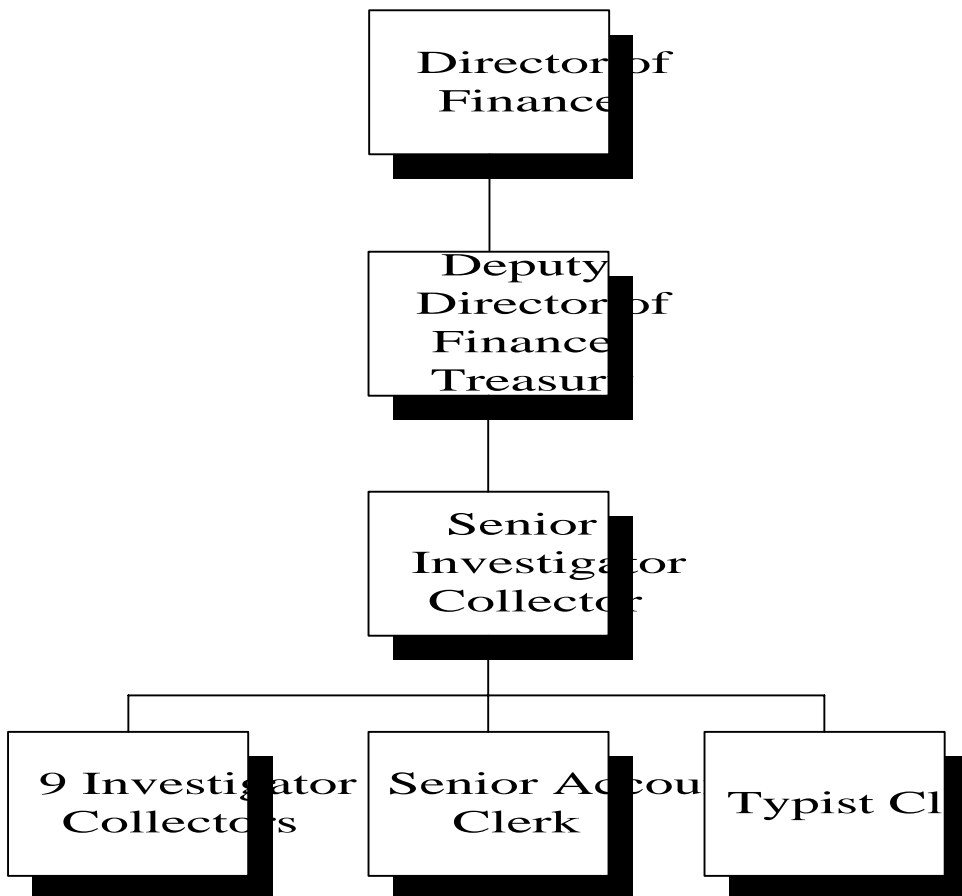
Types of Businesses	Number of Licensees	Total Revenue
Exempt Branches	8,770	\$ 0
Exempt Other	3,141	0
Insurance Brokers*	125	24,582
Psychiatrist/Therapists/Counselors	214	32,118
Engineering Services	215	44,616
Taxi Cab Drivers	396	59,400
Computer Consultants	593	93,954
Gardeners	613	93,390
Handyman	664	100,608
Real Estate Brokers*	699	118,980
Accounting/Bookkeeping	658	124,062
Beauty Parlors/Manicurists (cosmetologists)*	843	129,378
Attorneys/Lawyers	742	137,604
Food, Related Products	469	141,954
Electronics/Radio/TV/Computer	536	142,320
Cleaning/Janitorial	926	146,208
Miscellaneous Retail	1,055	181,050
Consultants	1,182	188,280
Computer/Office Machines	215	193,378
Doctors and Dentists	1,050	200,846
Miscellaneous Manufacturing	275	222,906
Miscellaneous Business Services	1,288	238,362
Restaurants/Deli	1,300	305,844
Electronic/Electrical	305	307,490
Residential Landlords	2,932	557,720
Contractors	4,892	801,449
Commercial Landlords	2,633	919,730
Other	15,083	3,254,778
Totals	51,814	\$8,761,007

* As of January 2, 1994, the City's business license tax database showed 833 licensed cosmetologists, 704 licensed real estate brokers, and 128 licensed insurance brokers.

Organization Chart

The following is the organization chart of the Finance Department/ Treasury Division, Licenses and Permits section, which is responsible for the administration of the business license tax.

CHART II



A senior investigator collector supervises the Finance Department/ Treasury Division's Licenses and Permits section. This section performs the following functions:

1. Administer billing and collection of the general business license tax
2. Administer issuance of regulatory permits and collection of fees
3. Enforce tax, license, and regulatory ordinances by conducting field investigations

Each of the nine investigator collectors is assigned to a specific business district for the billing and collection of business license taxes. The investigators identify businesses to be taxed, send the necessary forms, and bill and collect the appropriate tax and any penalties and interest due. Investigators get a daily report on accounts that are paid or closed and reports on delinquent accounts for follow up. In addition to taking turns working at the counter helping customers, the nine investigators also update the City's business license tax database.

Department's Major Accomplishments

Appendix I shows the Finance Department's major accomplishments in the administration of the City's business license taxes. Among other things, during 1992-93 and 1993-94 the Finance Department has

- Permanently assigned two investigator collectors to the business tax counter.
- Began cross training business tax investigators in sewer service and use and in accounts receivable collections.
- Improved education and outreach efforts undertaken to expose as many of the business communities as possible to the business tax requirements in the city of San José.

- Resolved a multi-year backlog of over 1,600 pending “lead” accounts, resulting in collection of approximately \$360,000.
- Resolved a multi-year backlog of uncollected delinquent accounts and implemented procedures to prevent a recurrence.
- In coordination with ISD, developed computer matches of commercial and residential property owners using County Assessor records with the business tax database to identify business tax leads.
- Audited all branch accounts to insure their accuracy. Adjusted accounts based on the updated information provided by the owners and from investigator collectors’ research.
- Audited all residential, commercial, and industrial landlord business tax accounts to verify the accuracy of current and future billings.
- Mailed notices to all exempt accounts expiring in September and December 1993 and in March 1994 to verify the exemptions were still valid.
- Revised procedures for application for handbill permits.
- Revised and updated the business tax procedures manual from cover to cover and distributed to all investigator collectors and other personnel in the Treasury Division.
- Initiated research and collection efforts to improve compliance with business tax requirements by distributors of home-party-based products such as Herbal Life, Amway, Avon, etc.
- Implemented monthly reporting format for investigator collectors to monitor collection activity, performance, and workload.
- Refined weekly investigator collector staff meetings to review codes and collection techniques and provide regular training in specific areas needing improvement.

- Began participation in the state of California offset program to effect collection of unpaid business tax accounts for which the City has received judgments.
- Assigned investigator collectors to participate in City training classes to develop and/or improve skills in teambuilding, negotiations, effective meetings, forecasting, communications, computer skills, and TQM.
- Implemented procedures to review all City billing databases for other delinquent accounts owed to the City by the same customer and to file small claims action simultaneously for all money owed by the customer.
- Formed focus groups to investigate such issues as:
 - Sales tax procedures
 - Automated collection systems
 - Reclassification of the investigator collector series

SCOPE AND METHODOLOGY

This is the first report on the audit of business license taxes. This report focuses on our review of the City's business license tax database as compared to lists of licensees obtained from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization. Our audit objectives were to

- Determine whether there are persons or businesses that should be, but are not, paying the City's business license tax;
- Determine the steps the City has taken to ensure that persons or businesses operating in the City are paying the business license tax; and
- Determine what other cities do to identify and pursue unlicensed businesses within their jurisdictions.

In addition to these state licensing agencies, we contacted and obtained membership lists from the San José Real Estate Board. We also contacted the business license tax units of other cities as well as members of the California Municipal Business Tax Association. The cities' staffs to which we talked were helpful in relating their strategies and procedures for identifying and pursuing unlicensed businesses within their jurisdictions.

During our review, we referred to the City's business license tax database, which the Information Systems Department maintains. The Finance Department/Treasury Division's Licenses and Permits section updates the database and uses it to prepare business license tax billings and renewals as well as investigators' reports of (1) business profiles, (2) business license tax payments, (3) delinquent accounts, and (4) closed accounts. We compared the database to lists of businesses

that the above-mentioned state licensing agencies provided to us. We performed only limited testing to determine the accuracy and reliability of the information in the database. Such testing included observing and walking through database updating procedures at the Treasury Division. We did not review the Information Systems Department's general and specific application controls for the database.

FINDING I

THE CITY MAY BE ABLE TO COLLECT \$7.3 MILLION IN BACK BUSINESS LICENSE TAXES, PENALTIES, AND INTEREST FROM REAL ESTATE BROKERS AND AGENTS, COSMETOLOGISTS, INSURANCE BROKERS, AND SALES TAX PERMIT HOLDERS AND INCREASE ANNUAL BUSINESS LICENSE TAXES BY \$1.6 MILLION

Unless specifically exempted by the San José Municipal Code, all persons or businesses conducting business in the city of San José (City) are required to pay an annual business license tax. Any person who fails to pay the tax on or before the due date is liable for a penalty of 25 percent of one year's tax due. Should the tax remain unpaid for a period exceeding one month beyond the due date, an additional 25 percent penalty plus interest of 1.5 percent per month is assessed. Our review of real estate brokers and agents, cosmetologists, insurance brokers, and sales tax permit holders revealed that the City may be able to (1) collect \$7.3 million in back business license taxes, penalties, and interest and (2) increase annual business license taxes by an estimated \$1.6 million. It should be noted that our estimate of additional revenues may include real estate brokers and agents, cosmetologists, and insurance brokers who are not required to pay business license taxes because they are inactive, employees, or otherwise exempt. To the extent our estimate includes such persons, our estimate of additional business license taxes will be overstated. By contacting suspected unlicensed businesses through a mass-mailing program and implementing a tax amnesty program, the City may be able to cost-effectively recover a substantial portion of unpaid back business license taxes and increase its business license tax base. Furthermore, by using other City departments to inspect for current City business licenses, the City will be able to use existing resources to increase business license taxes. Finally, it should be noted that our estimate of additional business license taxes did not include numerous categories such as exempt branches, accounting and bookkeeping,

consultants, attorneys, miscellaneous business services, restaurants, and janitorial services. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimates shown above.

The Business License Tax

Unless specifically exempted by the San José Municipal Code, all persons or businesses conducting business in the city of San José are required to pay an annual business license tax. The basic annual business license tax rate is \$150. Businesses other than residential and commercial landlords and mobile home parks owners pay an additional \$18 tax for each employee in excess of eight employees. Residential and commercial landlords and mobile home park owners pay incremental taxes based on the number of Municipal Code-specified units. Table I shows the City's business license tax rates.

TABLE I
CITY OF SAN JOSÉ
BUSINESS LICENSE TAX RATES

	Basic	Increment	Maximum Tax
General License Tax (Most businesses)	\$150	\$18 per employee over 8	\$25,000
Residential Landlords	\$150	\$5 per rental unit over 30	\$5,000
Commercial Landlords	\$150	\$0.01 per sq. ft. over 15,000 sq. ft.	\$5,000
Mobile Home Park Owners	\$150	\$5 per lot over 30	\$5,000

Back Taxes, Penalties, And Interest

Any person who fails to pay the tax on or before the due date is liable for a penalty of 25 percent of one year's tax due. Should the tax remain unpaid for a period exceeding one month beyond the due date, an additional 25 percent penalty of one year's tax plus interest of 1.5 percent per month is assessed. If a person fails to obtain a valid certificate, the business license tax due may be up to three years of back taxes together with applicable penalties and interest, as well as the current year's tax.

Municipal Code, section 4.76.290, states,

- A. *Any person who fails or refuses to pay any business tax required to be paid pursuant to this chapter on or before the due date shall pay penalties and interest as follows:*
 - 1. *A penalty equal to twenty-five percent of the amount of the tax in addition to the amount of the tax, plus interest on the unpaid tax calculated from the due date of the tax at a rate established by resolution of the city council; and*
 - 2. *An additional penalty equal to twenty-five percent of the amount of the tax if the tax remains unpaid for a period exceeding one calendar month beyond the due date, plus interest on the unpaid tax and penalties calculated at the rate established by resolution of the city council.*
- D. *If any person has failed to apply for and secure a valid certificate, the business tax due shall be that amount due and payable from the first date on which the person was engaged in business in the city together with applicable penalties and interest . . .*

Our Review Of Real Estate Brokers And Agents, Cosmetologists, Insurance Brokers, And Sales Tax Permit Holders Revealed That The City May Be Able To Collect \$7.3 Million In Back Business License Taxes, Penalties, And Interest

Our review of businesses subject to the business license tax revealed that certain businesses which are subject to the business license tax have been operating in San José without City business licenses. We identified the unlicensed businesses by comparing lists of licensees from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization to the City's business license tax database. Table II summarizes the estimated unlicensed businesses, annual taxes, and three years' taxes plus penalties and interest due. The City Auditor's Office estimates total potential collections of \$7,275,138 in three years' back business license taxes, penalties, and interest.

TABLE II
UNLICENSED BUSINESSES,
ESTIMATED ANNUAL TAXES, AND
THREE YEARS' TAXES PLUS PENALTIES AND INTEREST

	City Auditor's Estimates		
	Estimated Unlicensed Businesses	Annual Taxes	Three Years' Taxes ¹ Plus Penalties and Interest
Real Estate Brokers and Agents	3,897	584,550	\$2,837,388
Cosmetologists	4,540	681,000	3,305,328
Insurance Brokers	1,084	162,600	788,859
Sales Tax Permit Holders	914	137,100	343,563
Total	10,435	\$1,565,250	\$7,275,138

¹ For purposes of calculating the three years' back taxes, we included the current year's taxes, which is the City's of customary practice.

Real Estate Brokers And Agents

According to the California Department of Real Estate, as of March 1994, there were 8,498 real estate brokers and agents whose business addresses were within the cities of San José, Campbell, Cupertino, Gilroy, Morgan Hill, Milpitas, Santa Clara, and San Martin (unincorporated). Our review of the City's business license tax database indicated that only 704 real estate brokers held current City business licenses as of January 1994. Furthermore, the City's business license tax database did not include any of the real estate agents in the list the California Department of Real Estate provided to us. According to the City Attorney, the City should treat real estate salespersons (agents) as independent contractors for business tax purposes unless it can be established, on a case-by-case basis, that a true "employer/employee" relationship exists between the broker and salesperson.

In a letter dated August 19, 1992, (Appendix E) the City Attorney stated,

The City's business tax is imposed on all persons doing business in the City of San José. The amount of the tax is based on, with limited exception, the number of employees. An "Employee" is defined as "each and every person engaged in the operation or conduct of any business, whether as owner, member of the owner's family, partner, associate, agent, manager or solicitor " Independent contractor's are not included as employees. . . .

For purposes of unemployment insurance, section 650 of the Unemployment Insurance Code provides that a real estate salesperson who receives compensation solely on a commission basis is not an "employee." Most significantly, for purposes of federal income taxes, Internal Revenue Code section 3508 provides that in case of services performed by a qualified real estate agent the individual performing such services shall not be treated as an employee

The City should therefore treat real estate sales persons as independent contractors for business tax purposes unless it can be established, on a case by case basis, that a true "employer/employee" relationship exists between the broker and salesperson.

Of the 8,498 real estate brokers and agents whose business addresses are within the cities of San José, Campbell, Cupertino, Gilroy, Morgan Hill, Milpitas, Santa Clara, and San Martin (unincorporated), we estimate that 7,794 have not paid the City's business license tax. Of the latter number, we estimate that 50 percent, or 3,897, are located within the city of San José.² Therefore, the City could collect additional business license taxes from the estimated 3,897 real estate brokers and agents whose offices are located within the City. The following shows the computation of three years of back taxes plus penalties and interest:

TABLE III
UNLICENSED REAL ESTATE BROKERS AND AGENTS

	Current	1993	1992	1991	Total
Unlicensed Real Estate Brokers & Agents	7,794				
Less 50% for Out-of-Town Businesses	(3,897)				
Estimated Unlicensed Local Businesses	3,897	3,897	3,543	3,221	
10% Yearly Increase		354	322	293	
Net Unlicensed Real Estate Brokers & Agents	3,897	3,543	3,221	2,928	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$584,550	\$531,450	\$483,150	\$439,200	\$2,038,350
Potential Additional Business License Taxes and Penalties	\$876,825	\$531,450	\$483,150	\$439,200	\$2,330,625
Interest	\$ 0	\$ 95,661	\$173,934	\$237,168	\$ 506,763
Total Potential Additional Business License Taxes, Penalties, and Interest	\$876,825	\$627,111	\$657,084	\$676,368	\$2,837,388

² The San José Real Estate Board's 1993-94 membership directory shows that about 50 percent of its members have San José addresses. In addition, 52 percent of the houses that its members sold in 1993 were located in San José.

It should be noted that, although we excluded them from our calculations, real estate brokers and agents who are located outside of San José but who do business in San José may be required to pay the City's business license tax. Specifically, the City charges out-of-town persons or businesses a prorated business license tax based on the number of days the persons or businesses worked in San José during the year as follows:

5 days or less	\$0
6 to 29 days	\$37.50
30 to 89 days	\$56.25
90 to 119 days	\$75.00
120 days or more	\$150.00

Therefore, to the extent that prorated business license taxes could be collected from real estate brokers and agents who are located outside of San José but who do business in San José, our estimate of additional business license taxes will be understated.

Cosmetologists

According to the California Department of Consumer Affairs, as of March 1994, there were 5,373 licensed cosmetologists whose business addresses were within the city of San José. Of this number, we estimate that 4,540 have not paid the City's business license tax. Our review of the City's business license tax database indicated that only 833 cosmetologists held current City business licenses as of January 1994.

We estimate that the City could collect business license taxes from an additional 4,540 cosmetologists whose businesses are located within the City.

Table IV shows the computation of three years of back taxes plus penalties and interest.

TABLE IV
UNLICENSED COSMETOLOGISTS

	Current	1993	1992	1991	Total
Estimated Unlicensed Cosmetologists	4,540	4,540	4,127	3,752	
10% Yearly Increase		413	375	341	
Net Unlicensed Cosmetologists	4,540	4,127	3,752	3,411	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$681,000	\$619,050	\$562,800	\$511,650	\$2,374,500
Potential Additional Business License Taxes and Penalties	\$1,021,500	\$619,050	\$562,800	\$511,650	\$2,715,000
Interest	\$ 0	\$111,429	\$202,608	\$276,291	\$ 590,328
Total Potential Additional Business License Taxes, Penalties, and Interest	\$1,021,500	\$730,479	\$765,408	\$787,941	\$3,305,328

Insurance Licensees

According to the California Department of Insurance, as of March 1994, there were 2,650 insurance licensees whose business addresses were within the city of San José. Of this number, we estimate that 1,084 have not paid the City's business license tax. Our review of the City's business license tax database indicated that only 128 insurance brokers held current business licenses as of January 1994. According to the City Attorney, although agents of insurance corporations are exempt from local taxes under the state constitution, cities can impose local business taxes upon insurance brokers.

In a letter dated October 9, 1992, (Appendix F) the City Attorney stated,

Article XIII, Section 28 (f) of the California Constitution exempts insurers from all state and local taxes or licenses [T]his exemption from local taxes applies to agents of insurance corporations. . . .

However, subsequent cases and the California Insurance Code distinguish an insurance broker from an insurance agent. While an agent is authorized by an insurer to transact insurance for the insurer and to contractually bind the insurer, a broker only is authorized to transact insurance with, not on behalf of, an insurer and has no authority to bind an insurer. Therefore, California courts have reasoned that, unlike agents, insurance brokers are not exempt under the state Constitution from local taxes, and cities may impose business taxes on insurance brokers.

Of the 2,522 insurance state licensees who do not pay the City's business license tax, we estimate that the City could collect business license taxes from 1,084 (43 percent). We base our estimate on the experience of the city of Pleasanton in which 30 of the 70 insurance licensees registered by Pleasanton were paying the business license tax.

Unlike the city of San José, the city of Pleasanton requires all insurance businesses, whether exempt or not, to register. To gain an exemption from paying the business license tax, the insurance licensee must submit acceptable proof of exemption, such as a certificate of authority from the California Department of Insurance. In the case of a self-employed insurance agent, he or she must respond to a questionnaire to determine his or her exemption eligibility. If the agent does not qualify for exemption based on the questionnaire, the agent may furnish additional proof that he or she is an agent of an exempt insurance company in order to be granted an exemption. Insurance businesses that are not granted specific exemption according to Pleasanton's requirements will have to pay the business license tax.

In addition to Pleasanton, we surveyed the cities of Berkeley, Los Angeles, Milpitas, Oxnard, Redwood City, San Leandro, Santa Clara, Stockton, and Sunnyvale regarding their practices in licensing insurance businesses. We found that all of these cities require all insurance brokers to pay. In San José, the

Licenses and Permits section of the Finance Department/Treasury Division does not have a program requiring all insurance agents and brokers to register with the City. As mentioned previously, 128 insurance brokers currently pay the City's business license tax. In addition, another 221 insurance agents have tax-exempt business licenses. However, these insurance businesses are a small fraction of the 2,650 insurance state licensees located in San José.

In our opinion, if San José follows Pleasanton's and other cities' practice of registering all insurance agents and brokers and granting exemption only to those who submit acceptable proof of exemption, the City could collect business license taxes from an additional 1,084 insurance state licensees whose offices are located in San José.

It should be noted that the San José Municipal Code already requires that any person desiring to claim exemption from paying the business license tax must furnish information showing eligibility for exemption. Section 4.76.610 states,

Any person desiring to claim exemption from the payment of a license tax shall make application therefor upon forms prescribed by the director of finance and shall furnish such information and make such affidavit as may be required. Upon the determination being made that the applicant is entitled to exemption from the payment of license taxes for any reason set forth in this chapter, the director of finance shall issue a free license to such person which shall show upon its face that the license is tax exempt.

In our opinion, based on the above provision, the City should require all insurance state licensees to register and to pay the business license tax unless they can furnish proof that they are exempt from the tax. Table V shows the computation of three years of back taxes plus interest and penalties.

TABLE V
UNLICENSED INSURANCE LICENSEES

	Current	1993	1992	1991	Total
Unlicensed Insurance Brokers	1,084	1,084	985	895	
10% Yearly Increase		99	90	81	
Net Unlicensed Insurance Brokers	1,084	985	895	814	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$162,600	\$147,750	\$134,250	\$122,100	\$566,700
Potential Additional Business License Taxes and Penalties	\$243,900	\$147,750	\$134,250	\$122,100	\$648,000
Interest	\$ 0	\$ 26,595	\$ 48,330	\$ 65,934	\$140,859
Total Potential Additional Business License Taxes, Penalties, and Interest	\$243,900	\$174,345	\$182,580	\$188,034	\$788,859

Sales Tax Permit Holders

The California State Board of Equalization (SBE) sends to the City's Finance Department a magnetic tape of San José sales tax collections which shows the names and addresses of sales tax permit holders. We reviewed the list for the quarter ended September 30, 1993, which showed the names and addresses of 21,573 permit holders. Of this number, we selected a sample which consisted of all 1,252 new permit holders and 5,559 from the established permit holders for a total sample of 6,811. By tracing our audit sample to the City business license tax database, we were able to identify 654 sales tax permit holders who did not have current City business licenses. Of the 654 that we identified as unlicensed, 556 were new permit holders as of the quarter ended September 30, 1993.

Further, by extrapolating our audit sample of established sales tax permit holders, we estimate that a total of 358 established sales tax permit holders did not have current City business licenses.

Therefore, based on our audit sample, we estimate that 358 unlicensed established sales tax permit holders and 556 unlicensed new sales tax permit holders did not have current business licenses. In Table VI, our computation shows that the City could collect approximately \$343,563 (\$260,163 plus \$83,400) in business license taxes, penalties, and interest from the estimated 914 (358 plus 556) unlicensed sales tax permit holders.

TABLE VI
UNLICENSED ESTABLISHED SALES TAX PERMIT HOLDERS

	Current	1993	1992	1991	Total
Unlicensed Established ³ Sales Tax Permit Holders	358	358	325	295	
10% Yearly Increase		33	30	27	
Net Unlicensed Sales Tax Permit Holders	358	325	295	268	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$53,700	\$48,750	\$44,250	\$40,200	\$186,900
Potential Additional Business License Taxes and Penalties	\$80,550	\$48,750	\$44,250	\$40,200	\$213,750
Interest	\$ 0	\$ 8,775	\$15,930	\$21,708	\$ 46,413
Total Potential Additional Business License Taxes, Penalties, and Interest	\$80,550	\$57,525	\$60,180	\$61,908	\$260,163

³"Established" sales tax permit holders are those who appeared in the SBE list in at least one quarter prior to the quarter ended September 30, 1993.

TABLE VII
UNLICENSED NEW SALES TAX PERMIT HOLDERS

	Current	1993	1992	1991	Total
Unlicensed New ⁴ Sales Tax Permit Holders	556				
Basic Annual Business License Tax	\$150				
Potential Additional Business License Taxes	\$83,400				\$83,400
Total Potential Additional Business License Taxes	\$83,400				\$83,400⁵

It should be noted that of the 1,252 new sales tax permit holders for the quarter ended September 30, 1993, we identified that 556, or 44 percent, did not have City business licenses. Accordingly, in our opinion, the Finance Department should regularly review the SBE's quarterly magnetic tape of sales tax collections for new sales tax permit holders who do not have City business licenses. The Finance Department should then determine if any permit holders so identified should have a business license and, if so, take appropriate action.

**Our Estimate Of Additional Revenues May Include
Real Estate Brokers And Agents, Cosmetologists, And Insurance Brokers
Who Are Not Required To Pay Business License Taxes**

In our computations of additional revenues we may have included some state-licensed real estate brokers and agents, cosmetologists, and insurance brokers who have been inactive in their professions during the year or who may have been employees rather than independent contractors. Such individuals would not be

⁴"New" sales tax permit holders are those who appeared in the SBE list for the first time for the quarter ended September 30, 1993.

⁵Our computation does not include penalties or interest for new sales tax permit holders.

required to pay the City's business license tax. To the extent our estimate includes such persons, our estimate of additional business license taxes, penalties, and interest will be overstated.

The Finance Department estimates that of the unlicensed businesses shown in Table II on page 14 of this report 754 real estate agents, 1,468 cosmetologists, and 638 insurance brokers are not subject to the City's business license tax because they may have been inactive in their professions during the period or may have been employees rather than independent contractors. As a result, in Appendix H, the Finance Department estimates that the City would be able to collect \$4,967,036 in additional business license taxes, penalties, and interest from real estate brokers and agents, cosmetologists, insurance brokers, and sales tax permit holders and would be able to increase annual business license taxes by \$1,382,196.

**Business License Tax Investigators Should Verify
The Number Of Employees Businesses Report
By Checking Their Payroll Tax Returns**

According to the Finance Department, the business license application form does not require businesses to substantiate the number of employees they report. In our opinion, the Finance Department/Treasury Division should implement procedures instructing the City's business license tax investigators to verify the number of employees business licensees report by checking their payroll tax returns. By so doing, the Finance Department can confirm whether real estate brokers and agents, cosmetologists, insurance brokers, and other professionals working for the business licensees are actually employees rather than independent contractors who would be subject to the City's business license tax. Furthermore,

the Finance Department should require any independent contractors currently reported as employees to apply for separate business licenses.

**The City May Be Able To Cost-Effectively Recover
A Substantial Portion Of Unpaid Back Business License Taxes
And Increase Its Annual Business License Tax Base**

The City could cost-effectively increase the City's annual business license tax base by (1) implementing a mass-mailing program for suspected businesses and persons operating without City business licenses; (2) implementing a tax amnesty program for such businesses and persons; and (3) using other City departments to review for current City business licenses.

Mass-Mailing Program For Suspected Unlicensed Businesses

By contacting suspected unlicensed businesses through a mass-mailing program, the City may be able to cost-effectively increase the business license tax base. Finance Department/Treasury Division already has a form letter that it uses to contact business owners who may be liable but have not applied for the business license.⁶ Other cities, such as Vacaville, also use form letters to inform unlicensed businesses regarding their business license tax regulations.

In the form letter for the mass mailing, the City should state that according to the San José Municipal Code, section 4.76.290.D, the unlicensed business owes business license taxes “*from the first date on which the person was engaged in business in the city together with applicable penalties and interest.*” The form

⁶ See Appendix D for a copy of the Finance Department/Treasury Division's form letter.

letter should also note that if the business is not liable for the business license tax the owner should present documentation justifying the exemption.

By implementing a mass-mailing program, the City can contact the numerous suspected businesses and persons operating without City business licenses without incurring the costs of an investigator's personal visit. During this audit, the City Auditor's Office was able to obtain the owners' names and addresses of businesses potentially subject to the City's business license tax. The Finance Department is welcome to use these lists in conducting the mass-mailing program.

The City Auditor's Office recognizes that the Finance Department/Treasury Division will require additional resources to conduct a mass-mailing program together with ongoing follow up. Accordingly, the Department should request funding in the 1994-95 budget year for any associated costs of new staff and additional operating expenses.

Tax Amnesty Program For Unlicensed Businesses

By implementing a tax amnesty program, the City also may be able to cost-effectively recover a substantial portion of unpaid back business license taxes and increase its annual business license tax base. In 1987, the City conducted an amnesty program for business license taxes in which the City netted more than \$835,000 out of an expected \$1 million. During the two-month amnesty period (October and November 1987), the City suspended late payment penalties and interest. The businesses that applied for the amnesty still had to pay the back taxes owed. Excluding the lost revenue due to waiver of penalties and interest, the amnesty program cost the City approximately \$69,000 to implement. Appendix B describes the 1987 San José Business License Tax Amnesty program.

The city of Los Angeles also implemented a tax amnesty program. Los Angeles' program, from October through December 1985, collected \$13.9 million and cost \$2.5 million in cash expenditures and lost revenue due to assignment of income-producing staff to the amnesty program. Under the program, Los Angeles waived \$6.8 million in penalties and criminal prosecution of delinquent taxpayers who met certain requirements. The requirements included paying all principal taxes and interest due, making a statement of gross receipts or other tax measure, and filing an application for amnesty. Los Angeles considered its amnesty program a success because it collected five times the estimated amount and added 1,500 new accounts to its tax base. Appendix C describes the Los Angeles amnesty program in detail.

By implementing a business license tax amnesty program similar to the program the City conducted in 1987 or the program the city of Los Angeles conducted in 1985, the City could collect substantial unpaid business license taxes from unlicensed businesses while adding new accounts to the business license tax base. Because the business license tax penalties waived under a tax amnesty program could be as much as 50 percent of one year's tax owed and three years of interest on unpaid taxes could be about 36 percent of the tax owed, a tax amnesty program that would generate \$5.3 million in tax collections may result in waived penalties of \$741,000 and waived interest of \$1.3 million. In addition, the Finance Department may need media consultant services and additional temporary staff to handle the telephone calls and paperwork connected with a business license tax amnesty program.

Using Other City Departments To Review For Current Business Licenses

The City does not have a formal strategy or plan to identify unlicensed businesses when various City staff members visit business establishments in their regular inspection visits. City departments whose staffs have regular contacts with business establishments (such as building, fire, and hazardous materials code inspectors and water meter installers or readers) do not have policies or procedures that require their staffs to (1) check whether the business establishments they inspect have current business licenses and (2) report unlicensed businesses to the Finance Department for investigation.

The city of Pleasanton requires its inspectors to check business licenses and report unlicensed businesses to their finance departments. Pleasanton instructs its utility meter readers and other city employees to report to its Finance Department the “House For Sale” signs of out-of-town realtors. The Pleasanton Finance Department then informs these realtors that they need to pay their business license taxes. If the realtors still refuse to pay, the city pursues the taxes through the small claims court. According to Pleasanton’s business license coordinator, the city has been successful in these small claims cases.

Before the city of Campbell transferred its fire inspection function to the Santa Clara County Central Fire District, Campbell fire code inspectors verified that the firm’s business license was current before they inspected the firm’s premises. The inspectors would then report any unlicensed businesses to the city clerk, whose functions included collecting the business license tax.

Since the City inspectors are already contacting businesses as part of their duties, using the City departments to review for current business licenses would be a cost-effective way to ensure that businesses operating in the City have current business licenses.

Potential Additional Revenues

It should be noted that our estimate of additional business license taxes did not include numerous categories such as exempt branches, accounting and bookkeeping, consultants, attorneys, miscellaneous business services, restaurants, and janitorial services. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimated \$7.3 million in back business license taxes, penalties, and interest and \$1.6 million in annual increased business license taxes shown in this report.

CONCLUSION

Our review of business license taxes revealed that certain businesses and persons who are subject to the City's business license tax have been operating in San José without City business licenses. We identified these businesses and persons by comparing lists of licensees from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization to the City's business license tax database. Our review also revealed that City departments whose staffs make regular contacts with business establishments do not have policies or procedures that require their staffs to check whether the business establishments they inspect have current business licenses or to report unlicensed businesses to the Finance Department for investigation. By using the business listings from these state licensing agencies to identify businesses and persons who should have City business licenses but do not, the City may be able to (1) collect \$7.3 million in business license taxes, penalties, and interest and (2) increase annual business license taxes by an estimated \$1.6 million.

Furthermore, by contacting suspected businesses and persons through a mass-mailing program, implementing a tax amnesty program, and using other City departments to inspect for current business licenses, the City may be able to cost-effectively recover unpaid taxes and increase its business license tax base. Finally, it should be noted that our estimate of additional business license taxes did not include numerous business categories. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimates in this report.

RECOMMENDATIONS

We recommend that the Finance Department/Treasury Division:

Recommendation #1:

Use the licensee listings of real estate brokers and agents (from the California Department of Real Estate), cosmetologists (from the California Department of Consumer Affairs), insurance licensees (from the California Department of Insurance), and sales tax permit holders--especially new permit holders--(from the California State Board of Equalization) to identify and pursue suspected unlicensed San José businesses. (Priority 1)

Recommendation #2:

Require all insurance licensees doing business within the City to register for the business license and to pay the business license tax unless they can furnish proof that they are exempt from the tax. (Priority 1)

Recommendation #3:

Implement a mass-mailing program to contact the suspected unlicensed businesses and inform them of the City's business license tax regulations and the penalties for non-filing. The form letter should note that if the business is not liable for the business license tax the owner should present documentation justifying the exemption. (Priority 1)

Recommendation #4:

Provide training and prepare written procedures to guide the business license tax investigators in identifying and pursuing unlicensed businesses. (Priority 1)

Recommendation #5:

Implement written procedures instructing the business license tax investigators to (1) verify the number of employees business licensees report by checking their payroll tax returns and (2) require any independent contractors currently reported as employees to apply for separate business licenses. (Priority 1)

Recommendation #6:

Upon approval of Recommendations #1, #2, #3, #4, and #5, request funding for any associated costs of necessary new staff and additional operating expenses. (Priority 1)

Recommendation #7:

Implement a limited-period amnesty program to encourage unlicensed businesses to voluntarily pay their business license taxes. (Priority 1)

Recommendation #8:

Upon approval of Recommendation #7, request funding for media consultant services to implement the business license tax amnesty program and for temporary staff to handle the tax amnesty telephone calls and paperwork. (Priority 1)

Further, we recommend that the Office of the City Manager and the Finance Department:

Recommendation #9:

Implement procedures to require staff members from City departments who make regular contacts with business establishments (such as building, fire, and hazardous materials code inspectors and water meter installers or readers) to (1) check whether the business establishments they inspect have current business licenses and (2) report unlicensed businesses to the Finance Department for investigation. (Priority 1)

Recommendations Requiring Budget Action

Of the preceding recommendations, #1, #2, #3, #4, #5, #6, #7, and #8 cannot be implemented absent additional funding. Accordingly, the City Manager should request during 1994-95 that the City Council appropriate an amount sufficient to implement Recommendations #1, #2, #3, #4, #5, #6, #7, and #8.

FINDING II

THE FINANCE DEPARTMENT DID NOT OBTAIN MUNICIPAL CODE-REQUIRED CITY COUNCIL APPROVAL BEFORE WAIVING \$4,542 IN LATE PAYMENT PENALTIES ON DELINQUENT BUSINESS LICENSE TAXES

The San José Municipal Code, section 4.76.505, prescribes that public market operators must pay their estimated business license taxes for the period December 1, 1993, to November 30, 1994, in three installments.

- The first installment was due on December 1, 1993;
- The second on April 1, 1994; and
- The third on June 1, 1994.

Municipal Code, section 4.76.290, empowers the City to collect penalties and interest on the taxes not paid by the due date. In addition, section 4.76.281 does not require the Director of the Finance Department to send the operator a notice of the business license tax due. Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542. By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval. The Finance Department should (1) implement procedures to ensure compliance with section 1.17.010 of the Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date and (2) request a City Attorney opinion on the City's ability to collect the \$4,542 penalty previously waived.

Business License Tax Payment Schedule For Public Market Operators

Ordinance No. 24211 amending the San José Municipal Code, chapter 4.76, prescribes that public market operators must pay their estimated business license taxes for the period December 1, 1993, to November 30, 1994, in three installments. The first installment was due on December 1, 1993; the second on April 1, 1994; and the third on June 1, 1994. Section 4.76.505 states,

- A. A public market operator shall pay, in advance, the tax required by Section 4.76.500 F, based on the estimated reserved space average for that fiscal year. . . .*
- b. The tax for the period December 1, 1993 to November 30, 1994 shall be due and payable in three equal installments and remitted to the City on December 1, 1993, April 1, 1994 and June 1, 1994.*
- B. Any delinquent payment of the estimated tax shall bear penalties and interest as set forth in Section 4.76.290.*

Late Payment Penalties Are Due If The Business License Tax Is Not Paid On Time

The Municipal Code prescribes a late payment penalty of up to 50 percent of one year's tax if the public market operator did not pay his business license tax on time. Section 4.76.290 states,

Any person who fails or refuses to pay any business tax required to be paid pursuant to this chapter on or before the due date shall pay penalties and interest as follows:

- 1. A penalty equal to twenty-five percent of the amount of the tax in addition to the amount of the tax, plus interest on the unpaid tax calculated from the due date of the tax at a rate established by resolution of the city council; . . .*
- 2. An additional penalty equal to twenty-five percent of the amount of the tax if the tax remains unpaid for a period exceeding one calendar month beyond the due date, plus interest on the unpaid tax and penalties calculated at the rate established by resolution of the city council.*

**The Finance Department Did Not Have To Send
The Operator A Notice Of The Business License Tax Due**

The Municipal Code does not require the Finance Department to issue billing notices to collect business taxes. Section 4.76.281 states,

The director of finance is not required to send a renewal, delinquency or other notice or bill to any person subject to the provisions of this chapter and failure to send such notice or bill shall not affect the validity of any tax or penalty due under the provisions of this chapter.

**By Allowing A Retroactive Extension Of The Filing Deadline,
The Finance Department Waived The \$4,542
In Late Payment Penalties Owed By A Public Market Operator**

Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542.

According to the Finance Department/Treasury Division, due to an error on the master business tax activity calendar, Finance staff did not send to the public market operator the billing for the December 1, 1993, installment until December 10, 1993 (see Appendix G). In the billing notice, the Finance Department required the public market operator to pay within seven days of the date of the billing notice and postponed the penalty date until the new deadline. Section 1.17.010 states,

Fees, deposits, bonds or charges for permits, licenses, activities or services provided for by this code may not be waived unless the waiver is otherwise specifically provided for in this code or unless waived by ordinance.

By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval.

CONCLUSION

Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542. By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #10:

Implement procedures to ensure compliance with section 1.17.010 of the San José Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date. (Priority 2)

Recommendation #11:

Request a City Attorney opinion on the City's ability to collect the \$4,542 penalty the Finance Department previously waived. (Priority 2)